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Insurance and Pension Markets in the European Union and Bulgaria (2005-2015)

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ABSTRACT

The banking sector historically played the leading role in lending to the real sector in the EU. This tradition defines the magnitude of the banking sector and the development of non-banking sector. The transformations in the EU to strengthen the financial system identify particular attention to alternative sources of finance - insurance companies and pension companies.
The new reality after the financial crisis formed positive expectations - the non-banking sector to maintain the economic performance and standards of living. The heightened expectations and real possibilities of government budgets created a new normality in which the non-banking sector is the main engine of the economy and reliable protection for society. The EU membership poses new challenges to the Bulgarian financial system. The convergence of practices in the insurance sector and the fragmentation of the pension insurance sector in the EU are properly applied in the Bulgarian economy. The overlapping in time of the two factors from the external environment, the EU membership and beginning of the crisis, changes the practices in the non-banking sector in response to a new type of competition and regulation, as well as social changes - the emergence of a middle class. The new situation involves risks and strategies that are reflected in the new regulatory regime.

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1. Introduction

The beginning of the global economic crisis creates a "new reality" (World Economic Forum, 2011, p. 1). Characteristic features of the economy are: multiple centers of power where decisions are taken to deal with the effects of the crisis; downturn in economic growth; reduced purchasing power; increasing consumer lending and reduce interest rates on deposits; tighter supervisory regime incl. supervision of intermediaries to the end customer; support from the parent company in terms of resources and sales channels and in terms of the popularity of the brand. The business climate is characterized by a high degree of volatility and a global race for competitiveness. The governments have a significant role to re-regulation of the business environment to the new social and environmental requirements.

The social and business expectations to the insurance and pension markets are as an alternative to the banking market to maintain the results of pre-crisis period. The public spending on the living standard, which are the subject of public interest since the beginning of the Great Depression, were planned based on optimistic actuarial estimates. Due to population aging, the citizens are more concerned about the financial difficulties after retirement and deterioration of health.

Since 2009, the economic development is performed in an environment defined as a “new normal” (Dabla-Norris et al., 2015, p. 4). The macroeconomic indicators do not give grounds to achieve the results before the crisis. The characteristics of the environment are: slowing economic growth; high degree of government intervention in private business through increased the regulation; reduced appetite for taking on risk; relatively high levels of unemployment in the private sector; rising prices of raw materials; increased pressure on companies to generate higher short-term profits for shareholders and stakeholders. The companies implement new strategies of mergers to achieve additional earnings from the effect of synergy. The supervisory regime aims to reward the executives and encourage investments in instruments such as bonds, at the expense of shares.

The insurance and pension markets are considered as a tool to fulfil the functions for distribution of wealth, poverty prevention and consumption smoothing. The market introduces new services: insurance against failure of private business and unemployment, retirement insurance with an employer (under the "Beveridge" system). The customer profile is modified: cultivation of customers (improving financial literacy and awareness for personal finance planning) and more demanding customers (low loyalty to financial services providers

and their replacement). The range of stakeholders is extended for identifying the financial capacity in dealing with climate changes and urbanization.

2. Discussion

In the new normal the governments have reduced budget options for maintaining the living standards of citizens and the financial possibilities of the business (Yoder et al., 2012, p. 16). In 2013 reported for 10% growth in global financial assets compared to 2007 is 29% (Brandmeir et al., 2014, p. 21). The bank deposits remain the preferred investment of personal finances, but there is a trend for citizens to take responsibility for their own security. After the onset of the global economic crisis, the non-bank market is a key driver for the economy and safe harbour for individuals and households in all countries. The insurance and pension insurance markets are effective asset protection from the effects of the crisis and maintain the standard of living (Figure 1).

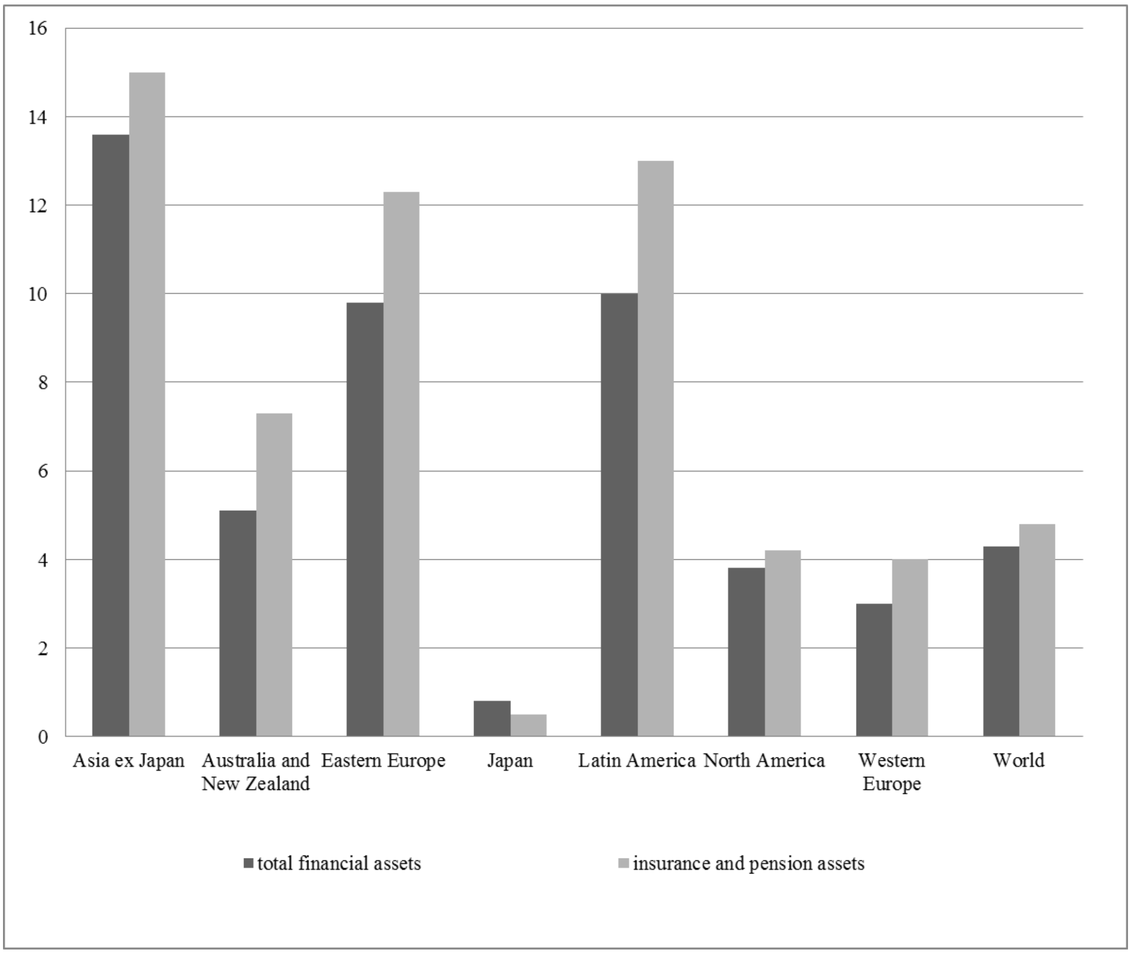

Figure 1
Average annual growth of gross financial assets and insurance & pension assets since 2007, in %; Source: Holzhausen, 2014, p. 3

The effects of the global economic crisis have given implications on the reallocation of capacity of households and citizens. The withdrawal from services in the banking market was transferred to the non-banking services market. The preferences to security and equilibrium in the investments, unlike other preferences, are universal in internationally (Figure 2).

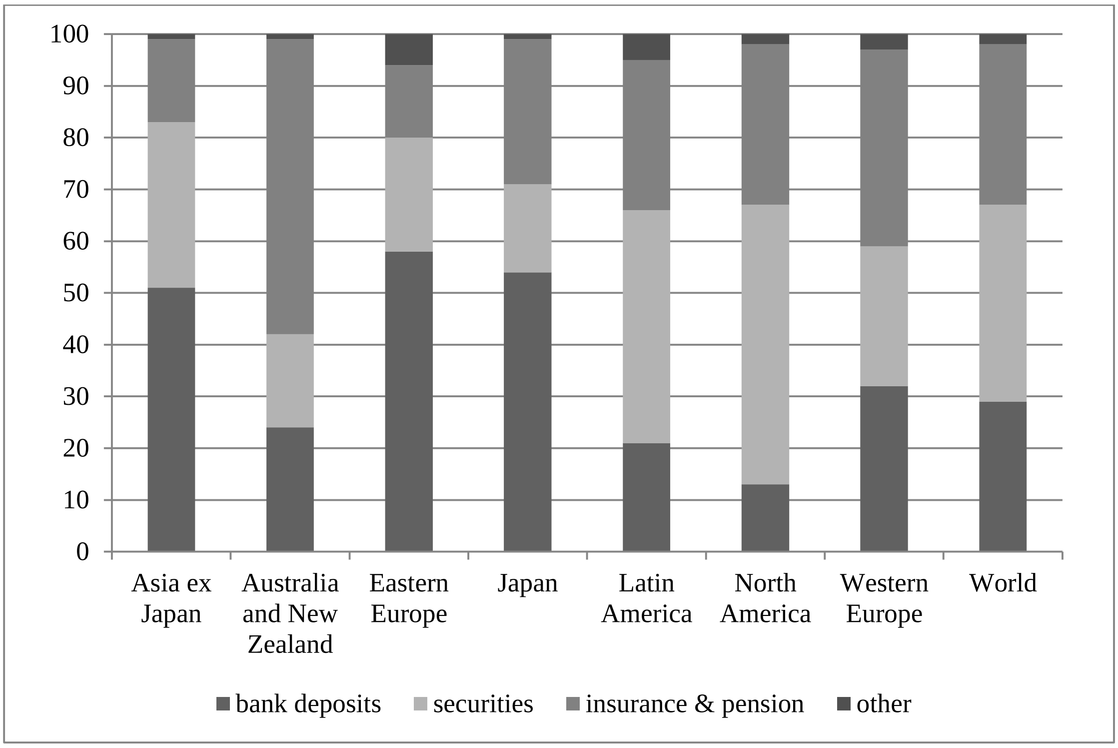

Figure 2
Asset classes as % of global gross financial assets (2013), in %; Source: Holzhausen, 2014, p. 4

3. The European Union non-banking market

Historically, the European Union (EU) non-banking market is highly fragmented, consisting of a number of national markets, which were largely developed independently. This fragmentation is the result of a mix of influences, including the nature of the national regulation and characteristics of shareholder ownership (path dependence). The new supervisory policies report positive results in response to the global economic crisis. Despite the progress in the regulation of non-banking markets in the EU, they remain fragmented within individual Member States, which gives reason to draw an analogy with the "Balkanization" of the banking market (Morgan Stanley and Oliver Wyman Group, 2013, p. 3).

The distinction between the non-banking markets in the EU and Bulgaria is in the formation of middle class. The reforms undertaken in health, education and retirement improved the demographic situation. Increasing the proportion of citizens with higher

education contributes to the formation of a middle class with high income, incl. increase of personnel costs for insurance and pension funding.

4. The case of Bulgarian non-banking markets

For Bulgaria the EU membership in 2007 coincides in time with the effects of the global economic crisis. The EU membership has removed barriers to the free movement of human resources and breeds high expectations for improve living standards. It creates preconditions for greater wealth and demand on protection of status through funding of life insurance and pension insurance.

The negative effects of membership are caused by risks typical for other Member States, and as a new for Bulgaria. The EU membership gave basis for comparison of macroeconomic conditions. For Bulgaria the public spending for age and early retirement constitutes 6.8% (% of GDP for 2007), other pensions (disability) - 1.4%. The forecasts are for an increase in total public spending on pensions to 10% during the period 2040-2050, along with Denmark and Estonia (Eichhorst et al., 2011, p. 22). For example, the trend towards increasing age is similar for all EU countries, while the profitability of the Bulgarian pension funds remained below average levels (Figure 3).

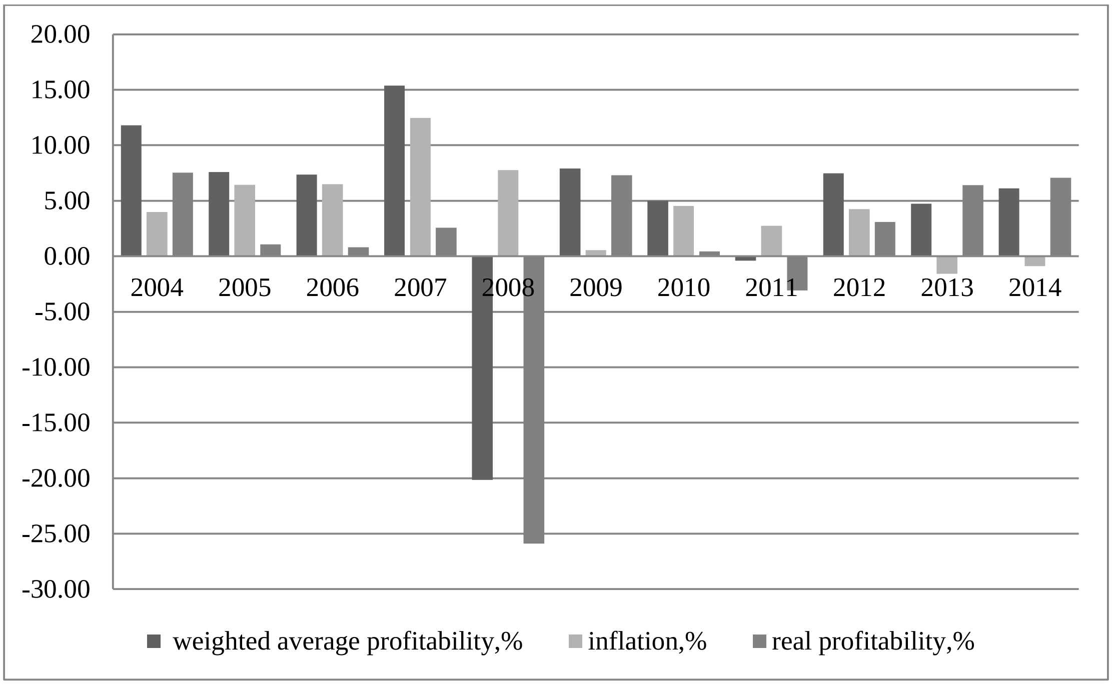

Figure 3
Profitability of the universal pension funds in Bulgaria

4.1. Insurance market

The insurance market in Bulgaria follows the trends in the EU. They should be considered as a threat due to his new nature:

- The application of the third generation of EU directives. The new format of the insurance market increases competition and accompanying effects: increase product quality and reduce the cost of services; better diversification of insurance and investment risks which could have a positive effect on consumers through increased choice of insurance services.
- Influx of European insurers by notification regime. To facilitate cross-border sales of the companies licensed in the EU, with offered the option of the possibility to operate in other Member States by notification. The single European license constitutes grounds for insurance companies to expand their operations in Eastern Europe: in 2015 in Bulgaria there are 12 insurers from a Member States operating under the right of establishment.
- Compliance with the more stringent capital requirements. The Directive "Solvency II" is a catalyst for changes towards reorganization of the insurance companies and restructuring their operations. The implications for the insurance market are consolidation of back-office operations and outsourcing of additional customer services such as call centers, incl. in Bulgaria.
- Increasing of local ownership. For the past ten years, in the insurance market in Bulgaria has not entered a new foreign company by license regime. The share of foreign shareholders in the insurance market decreased from 63% (2007) to 52% (2014).
- Adapting to climate risk. The climate changes require anticipating of financial capacity to meet not only the claims of citizens and businesses, but also of natural disasters linked to global changes (floods and snow storms).

The dynamics in the ownership of the insurance companies in Bulgaria is determined by:

- Effects of the global economic crisis. There are two cases where the withdrawal of foreign companies from the Bulgarian market was takeover of their activities from a local insurer.
- Changeover to supervision by a foreign authority. There are two insurance companies which passed under surveillance by foreign competent authority due to pursue business under the European single license.
- Application of the EU directives. The re-licensing of health insurance companies in the non-life insurance companies increases the number of insurers in Bulgaria in most largely.

In the Bulgarian market of insurance services have observed differences in activity caused by the origin of the capital:

- the foreign insurers prefer the strategy to sure profits and focus on life insurance and property insurance;
- the local insurers choose a strategy for rapid growth in market share through price war and organic growth; without acquiring of competitors; focusing on the "insurance against civil liability" (Third party liability insurance), which is mandatory by law.

4.2. Pension insurance market

The pension insurance market in Bulgaria, like in the other Member States of the European Union, is developed relatively independently and there was no convergence of practices:

- Free movement of pension services. The current Directive on occupational pension funds introduced the principles of the "prudent man" and of the mutual recognition of regulation systems (single license for pension funds). It establishes a prerequisite for cross-border provision of pension services. A progress has been made in removing barriers to labour mobility, such as the coordination of tax systems for pensions. Despite progress on removing barriers to freedom to provide services and free movement of human resources, yet have differences across countries in terms of funding rules.
- Free movement of human resources. The existence of „portability" enables EU citizens to acquire and retain their supplementary pension rights. Since 2013 the principle of the "outgoing worker" includes cases of labour mobility in terms of supplementary pensions, i.e. the possibility of keeping pension entitlements by transferring them to a new scheme in the event of professional mobility. For harmonization of the internal market for pension services is provided for implementation a common European "personal pension plan" that poses challenges for the protection of pension schemes of citizens and to meet future obligations for pension companies.

The new risks of pension market in Bulgaria concern the degree of preparedness to the new market situation:

- Behavioural risk. The trend individual investors to trade unprofessional leads to unnecessary transaction costs, low diversification of the portfolio, imbalance of risk profile

and ultimately - to poor portfolio even in a good macro-financial situation. The pension insurance market should increase the financial literacy of the clients.

- Longevity risk. The aging population is a major challenge for pension systems in all Member States of the EU (European Commission, 2012, p. 2). The longevity risk is the risk of payment of pensions and benefits for longer than expected and increase the time till retirement. Twenty of the 28 Member States have increased the retirement age from 2010, with which is gave an answer to the imbalance between the demographic situation and the opportunities for pension insurance. The deterioration of the demographic situation in the EU, population ageing and low birth rate, supplemented for Bulgaria with an emigration flow.

The challenges of the insurance market and pension insurance market in Bulgaria are dictated by international good practices and commitments of European membership:

- The application of EU directives for recovery and restructuring of financial intermediaries. The leading role of the integration is assigned to the national regulator. For this purpose the financial intermediaries will be evaluated by independent external persons and institutions with high professional reputation by methodology developed by the Financial Supervision Commission in cooperation with the competent European authorities.
- The prospect for the markets is aimed at determining the companies of systemic importance for the European market. Their definition should not be compared with the strategy "too big to fail". These companies will be subjected to stress tests to be in condition to deal with negative scenarios in the economy and markets. The implementation and evaluation of the stress tests will be entrusted to a new body, a Steering Committee. It will be chaired by the Financial Supervision Commission and representatives of European Insurance and Occupational Pensions Authority, Ministry of Finance and the Bulgarian National Bank, and an observer from the European Commission.
- Create a restructuring fund for investment firms. It will be filled by contributions from companies themselves and will serve as a financial buffer for risk situations.

5. Conclusions

The effects of the global economic crisis have defined a new role for the non-banking sectors. The insurance and pension insurance funds are seen as a key factor in systemic risk and lending to the economy. The new normality considers the sustainable development in the long term for the national economy and businesses as well for the individuals and households. The doubling of invested assets in the non-banking sector sets new expectations and requirements of the sector for him role of "patient investor".

The deregulation in the EU raises the competition to be determined by the companies themselves, not by supervisory policy. The harmonization lead to increased competition and the advantages by horizontal cooperation as a separate non-bank market as well in another Member State of the EU. The biggest challenge facing the sector is adapting to the demographic situation and implementation of the model "Life cycle of the customer". Secondary effects from the development of global goods (IT products) further provide advantages relative to the non-banking sector in comparison to the banking sector.

The re-regulation achieves integrated supervisory structure. Challenges remain for the removal of restrictions on the free movement in the EU and the fragmentation of national markets. On the other hand, liberalization facilitates the penetration of new markets, incl. in the Bulgarian market. The main factor for the development of non-banking sector remains solvency control by the supervisory authority of the home country.

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